

office of NSCC. All submissions should refer to File No. SR-NSCC-95-07 and should be submitted by August 15, 1995.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.<sup>7</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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[Release No. 34-35982; File No. SR-OCC-95-03]

**Self-Regulatory Organizations; The Options Clearing Corporation; Order Approving a Proposed Rule Change Relating to OCC's Exercise-by-Exception Procedures Applicable to Expiring Index Options**

July 18, 1995.

On February 16, 1995, The Options Clearing Corporation ("OCC") filed with the Securities and Exchange Commission ("Commission") a proposed rule change (File No. SR-OCC-95-03) pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act").<sup>1</sup> Notice of the proposal was published in the **Federal Register** on April 11, 1995.<sup>2</sup> No comment letters were received. For the reasons discussed below, the Commission is approving the proposed rule change.

**I. Description of the Proposal**

The purpose of the proposed rule change is to modify the exercise threshold for expiring index option contracts, including American,<sup>3</sup> European,<sup>4</sup> and Capped<sup>5</sup> Quarterly Index Expiration option contracts, carried in a clearing member's customer account in connection with OCC's exercise-by-exception ("ex-by-ex") processing procedures. The ex-by-ex exercise threshold used for flexibility structured index options is not effected by the rule change.

Ex-by-ex processing presumes that clearing members desire to exercise all options that are in-the-money by a

specified threshold immediately prior to expiration. Accordingly, all options subject to ex-by-ex processing are identified as being in-the-money, at-the-money, or out-of-the-money in a report provided to each clearing member through OCC's Clearing/Management and Control System ("C/MACS")<sup>6</sup> or by hard copy on each expiration date. After receipt and review of its report, each clearing member resubmits its report to OCC reflecting that the clearing member is instructing OCC to exercise all options that are in-the-money by the certain threshold amount. However, the clearing member can issue contrary instructions ("Contrary Exercise Advice") to OCC by notating on the report additional contracts it desires to exercise and contracts that are in the money by the threshold amount that it does not want exercised.

OCC's Rules currently specify two ex-by-ex processing thresholds for index options.<sup>7</sup> The first threshold applies to index options carried in clearing members' customers' accounts, and the second threshold applies to index options carried in all other clearing members' accounts.<sup>8</sup> The current aggregate price threshold for customer positions is \$25.00 per index option contract, and the aggregate price threshold for all other positions is \$1.00 per index option contract. OCC's rule change reduces the aggregate price threshold for customer positions to \$1.00 per index option contract. Now, any index option contract position, whether carried in clearing members' customers' accounts or in any of their other accounts, in-the-money by that amount or more, will be exercised immediately prior to expiration unless the clearing member submits a timely, contrary instruction to OCC. The proposed change to the threshold for ex-by-ex processing of certain index options carried in customers' accounts will not affect clearing members' obligations to their customers or correspondent brokers, which are determined by contract and by generally applicable principles of law.

**II. Discussion**

Section 17A(b)(3)(F) requires that the rules of a clearing agency be designed to promote the prompt and accurate clearance and settlement of securities transactions.<sup>9</sup> As discussed below, the

Commission believes that OCC's proposed rule change is consistent with this obligation because it should facilitate the prompt and accurate clearance and settlement of index options transactions by providing promptness and precision in the exercise of certain in-the-money index options.

The rule change should assure that certain customer-held index option contracts that are in-the-money by \$1 or more will not go unexercised unless the clearing member provides contrary exercise advice. By lowering the ex-by-ex threshold for index option contracts carried in customer accounts from \$25 to \$1, OCC has reduced the burden placed on clearing members to provide exercise advice on index options in-the-money by \$1 or more that are due to expire. Reducing the ex-by-ex processing threshold to \$1 per index option contract will mean that clearing members will have to manually identify for exercise only those customer-held index option contracts that are in-the-money by less than \$1.00 per contract; therefore, the cost associated with manually exercising customer-held index option contracts should be reduced. The proposal also should reduce the risk that a clearing member will fail to exercise a customer-held index option because under the new lower threshold only those options that are in-the-money by less than \$1.00 will not be exercised.<sup>10</sup>

Originally, the \$25 threshold was established because of the anticipation of transaction costs related to the exercise and settlement of index option contracts. Because index options are cash settled and the exercise fees for such options either do not exist, are waived, or are not expected to exceed the exercise proceeds, OCC believes that a lower ex-by-ex threshold can be applied and that its clearing members will not charge a fee for the cash settlement of an index option where a customer will be left with a loss.

**III. Conclusion**

On the basis of the foregoing, the Commission finds that the proposal is consistent with the requirements Section 17A(b)(3)(F) of the Act and the rules and regulations thereunder.

*It is therefore ordered*, pursuant to Section 19(b)(2) of the Act, that the proposed rule change (File No. SR-OCC-95-03) be, and hereby is, approved.

<sup>10</sup> As discussed earlier, clearing members can issue Contrary Exercise Advice instructions to exempt specified customer-held index option contracts from ex-by-ex processing.

<sup>7</sup> 17 CFR 200.30-3(a)(12) (1994).

<sup>1</sup> 15 U.S.C. 78s(b)(1) (1988).

<sup>2</sup> Securities Exchange Act Release No. 35566 (April 5, 1995), 60 FR 18435.

<sup>3</sup> OCC defines the term "American" option to mean an option contract that may be exercised at any time from its commencement time until its expiration.

<sup>4</sup> OCC defines the term "European" option to mean an option contract that may be exercised only on its expiration date.

<sup>5</sup> OCC defines the term "Capped" option to mean an option contract in a series which has a cap price at which all options in such series will be automatically exercised and which otherwise may only be exercised on its expiration date.

<sup>6</sup> C/MACS is an on-line, menu-driven system that allows OCC member firms to access or input trade information directly from or to OCC's clearing systems.

<sup>7</sup> Different ex-by-ex thresholds are applied to equity options.

<sup>8</sup> OCC Rule 1804(a) and (b).

<sup>9</sup> 15 U.S.C. 78q-1(b)(3)(F) (1988).

For the Commission by the Division of Market Regulation, pursuant to delegated authority.<sup>11</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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[Release No. 34-35993; File Nos. SR-Phlx-95-08, SR-Amex-915-12, SR-PSE-95-07, SR-CBOE-95-19, SR-NYSE-95-12]

**Self-Regulatory Organizations; Order Approving Proposed Rule Changes by the Philadelphia Stock Exchange, Inc., the American Stock Exchange, Inc., the Pacific Stock Exchange, Inc., the Chicago Board Options Exchange, Inc., and the New York Stock Exchange, and Amendment No. 1 by the Chicago Board Options Exchange, Inc., Amendment No. 1 by the Pacific Stock Exchange, Inc., Amendment No. 1 by the New York Stock Exchange, and Amendments Nos. 1 and 2 by the Philadelphia Stock Exchange, Inc., and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 3 by the Philadelphia Stock Exchange, Inc., Amendment No. 2 by the Pacific Stock Exchange, Inc., Amendment No. 2 by the Chicago Board Options Exchange, Inc., and Amendment No. 1 by the American Stock Exchange, Inc., to Adopt a 2½ Point Strike Price Pilot Program**

July 19, 1995.

## I. Introduction

On February 6, March 8, March 8, March 15, and March 22, 1995, respectively, the Philadelphia Stock Exchange, Inc. ("Phlx"), the American Stock Exchange, Inc. ("Amex"), the Pacific Stock Exchange, Inc. ("PSE"), the Chicago Board Options Exchange, Inc. ("CBOE"), and the New York Stock Exchange ("NYSE") (collectively the "Exchanges") submitted to the Securities and Exchange Commission ("SEC" or "Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> proposed rule changes to adopt a pilot program, whereby the Exchanges may select a certain number of their listed options for inclusion in a twelve month pilot program for the listing of strike prices at 2½ point intervals.

On March 10, 1995, the Phlx submitted to the Commission Amendment No. 1 to its proposal.<sup>3</sup> On

March 24, March 27, March 29 and March 29, 1995, the PSE, the CBOE, the Phlx, and the NYSE submitted Amendment Nos. 1, 1, 2, and 1, respectively, to their proposals.<sup>4</sup> On June 14, June 14, June 30, and July 6, the Phlx, the PSE, the CBOE, and the Amex submitted Amendments Nos. 3, 2, 2, and 1, respectively, to their proposals.<sup>5</sup>

Notices of the Exchanges' proposals and Amendment No. 1 to the CBOE's proposal, Amendment No. 1 to the PSE's proposal, Amendment Nos. 1 and 2 to the Phlx's proposal, and Amendment No. 1 to the NYSE's proposal were published for comment in the **Federal Register** on May 12, 1995.<sup>6</sup> No comments were received on

in Phlx Rule 1012, Commentary .05, in order to be consistent with CBOE Rule 5.5, Interpretation .01, in that strike price intervals may be \$10 "or greater" where the strike price is \$200 or more. See Letter from Gerald O'Connell, First Vice President, Market Regulation and Trading Operations, Phlx, to Michael Walinskas, Branch Chief, Office of Market Supervision ("OMS"), Division of Market Regulation ("Market Regulation"), Commission, dated March 10, 1995 ("Phlx Letter, dated March 10, 1995").

<sup>4</sup> The PSE, the CBOE, the Phlx, and the NYSE submitted amendments in order to codify the extended duration of the pilot program from six to twelve months. See Letters from Timothy Thompson, Attorney, CBOE, dated March 27, 1995 ("CBOE Letter, dated March 27, 1995"), Michael Pierson, Senior Attorney, PSE, dated March 24, 1995 ("PSE Letter, dated March 24, 1995"), to John Ayanian, Attorney, OMS, Market Regulation, Commission, and Letters from Gerald O'Connell, First Vice President, Phlx, dated March 29, 1995 ("Phlx Letter, dated March 29, 1995"), and Daniel Parker Odell, Assistant Secretary, NYSE, dated March 29, 1995 ("NYSE Letter, dated March 29, 1995"), to Michael Walinskas, Branch Chief, OMS, Market Regulation, Commission.

The Amex also submitted a clarifying amendment to extend the pilot program from six to twelve months, but did not codify the duration of the pilot program in its rules. See Letter from Claire McGrath, Special Counsel, Amex, to Michael Walinskas, Branch Chief, OMS, Market Regulation, Commission, dated April 3, 1995 ("Amex Letter, dated April 3, 1995").

The NYSE also submitted Amendment No. 1 to amend the text of proposed Supplementary Material .30(f) and .30(f)(i) to NYSE Rule 703 to list 2½ strike prices for 14 options, instead of 11 options as originally stated.

<sup>5</sup> The Phlx, PSE, CBOE, and Amex propose to amend their filings to conform with NYSE's proposal, in that the Exchanges would not require the listing of 2½ point strikes for all expiration months in selected option classes. See Letters from Gerald O'Connell, First Vice President, Market Regulation and Trading Floor Operations, Phlx, dated June 14, 1995 ("Phlx Letter, dated June 14, 1995"), David Semak, Vice President, Regulation, PSE, dated June 14, 1995 ("PSE Letter, dated June 14, 1995"), and Claire McGrath, Special Counsel, Amex, dated July 6, 1995 ("Amex Letter, dated July 6, 1995") to Michael Walinskas, Branch Chief, OMS, Market Regulation, Commission. See also Letter from Timothy Thompson, Attorney, CBOE, to John Ayanian, Attorney, OMS, Market Regulation, Commission, dated June 30, 1995 ("CBOE Letter, dated June 30, 1995").

<sup>6</sup> See Securities Exchange Act Release No. 35680 (May 5, 1995), 60 FR 25752 (May 12, 1995).

the proposals.<sup>7</sup> This order approves the proposed rule changes, as amended.

## II. Description of the Proposals

The Exchanges have submitted a joint proposal regarding the listing of 2½ point strike prices for selected equity options on a pilot basis. The pilot program would operate for a twelve-month period commencing on Monday, July 24, 1995, which is the Monday following the July 1995 expiration. Currently, the Exchanges list strike prices for equity options at 5 point intervals, where the strike price is between \$25 and \$200.<sup>8</sup>

The Exchanges propose to list selected options trading at a strike price greater than \$25 but less than \$50<sup>9</sup> (i.e., 27½, 32½, 37½, 42½ and 47½<sup>10</sup> at 2½

<sup>7</sup> Before the proposals were published for comment, the Committee on Options Proposals ("COOP") indicated that it favors the Exchanges' proposed 2½ point strike pilot program. See Letter from Michael Schwartz, Chairman, COOP, to Jonathan Katz, Secretary, Commission, dated April 5, 1995.

<sup>8</sup> See Securities Exchange Act Release No. 21985 (April 25, 1985), 50 FR 18595 (May 1, 1985) (Approving File Nos. SR-Phlx-85-9 and SR-PSE-85-9, amending both exchanges' policies regarding strike price intervals to conform to those of the other options exchanges); see also Securities Exchange Act Release No. 21929 (April 10, 1985), 50 FR 15258 (April 17, 1985) (File Nos. SR-CBOE-85-1 and SR-Amex-85-6).

<sup>9</sup> Proposed NYSE Rule 703, Supplementary Material .30(f) states that selected options may be listed at 2½ point strike price intervals "if the strike price for that series is greater than \$25.00, but is less than or equal to \$50.00." While the NYSE has proposed slightly different language to make the proposed rule consistent with other NYSE rules, the NYSE proposal allows for the listing of 2½ point strike prices at 27½, 32½, 37½, 42½ and 47½ in accordance with the terms of the pilot program. Telephone conversation between Gary Katz, Managing Director, Options and Index Products, NYSE, and John Ayanian, Attorney, OMS, Market Regulation, Commission, on May 2, 1995.

The Phlx and Amex submitted clarifying amendments to their proposals to indicate that the pilot program does not apply to options classes where the *underlying stock* is trading between \$25 and \$50, rather it includes equity options trading at a *strike price* between \$25 and \$50. See Letter from Gerald D. O'Connell, First Vice President, Market Regulation and Trading Operations, to Michael Walinskas, Branch Chief, OMS, Market Regulation, Commission, dated June 14, 1995 ("Phlx Letter, dated June 14, 1995"). See also Amex Letter, dated July 6, 1995, *supra* note 6.

<sup>10</sup> The applicable strike price codes will be Y 27½; Z 32½; U 37½; V 42½; and W 47½. The CBOE, Amex, and NYSE submitted clarifying amendments to their proposals to indicate, among other things, that each exchange intends to use these strike price codes for the additional strike price intervals. See Letter from Timothy Thompson, Attorney, CBOE, to John Ayanian, Attorney, OMS, Market Regulation, Commission, dated May 4, 1995 ("CBOE Letter, dated May 4, 1995"). See also Letters from Claire McGrath, Special Counsel, Amex, dated June 6, 1995 ("Amex Letter, dated June 6, 1995"), and James E. Buck, Senior Vice President, NYSE, dated June 15, 1995 ("NYSE Letter, dated June 15, 1995"), to Michael Walinskas, Branch Chief, OMS, Market Regulation, Commission.

<sup>11</sup> 17 CFR 200.30-3(a)(12) (1994).

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> The Phlx submitted Amendment No. 1 to add the phrase "or greater" to the last clause of the text